Daiwa Securities

Daiwa's View

Dollar resumes its singular appreciation

➢ Easy to buy dollars and JGBs under the new narrative

Fixed Income Research Section
FICC Research Dept.

Chief Strategist
Eiichiro Tani, CFA
(81) 3 5555-8780
eiichiro.tani@daiwa.co.jp

Daiwa Securities Co. Ltd.

Easy to buy dollars and JGBs under the new narrative

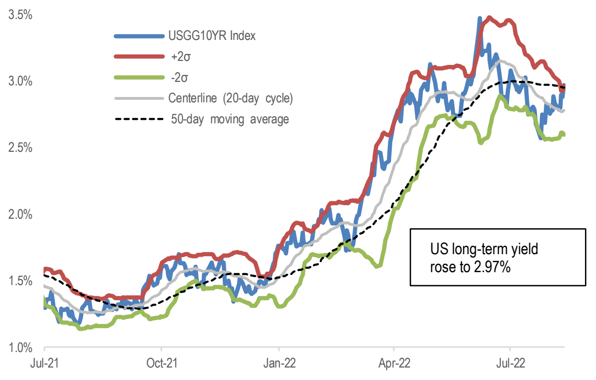
Dollar resumes its singular appreciation

◆ 10yr US Treasury yields retest 3%

Interest rates in Europe and the US rose sharply last Friday, with the 10yr UST yield momentarily testing 3% before closing at 2.97%. Breakeven inflation in the US is generally stable, with BEI at 2.56% for the 10yr and 2.35% for the 5yr. Given the Fed's unconditional commitment to stabilize inflation expectations (i.e., assuming trust in the Fed), it will be difficult for US long-term rates to climb above 3%.

However, this 2.97% represents a key level defining the upper Bollinger band (two standard deviations above the 50-day moving average), and it is necessary to constantly reaffirm whether this understanding (of Fed credibility) is correct. Although neither scenario is likely, there is a possibility that either (1) trust in the Fed will once again be shaken (recalling its stop-and-go policy of the 1970s) or (2) neither the US economy nor service inflation will slow even with large rate hikes taking the policy rate above 4%. If either of these patterns emerges, the US long-term rate could suddenly break above its range. In that sense, the Fed's speech at Jackson Hole this coming Friday will provide a litmus test of the Fed's credibility.

10Y US Yield



Source: Bloomberg; compiled by Daiwa Securities.

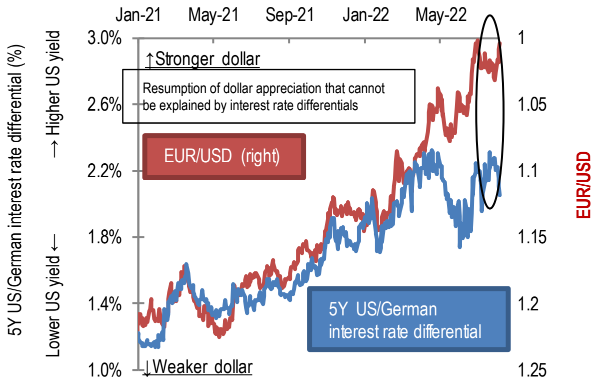
US Inflation Expectations

Source: Bloomberg; compiled by Daiwa Securities.

◆ Dollar resumes its singular appreciation

The dollar index (DXY) rose to 108.1 on Friday, its highest level since 14 July, when it posted a roughly 20yr high. Although Europe had a greater increase in yields than the US did last Friday (US 5yr +6bp vs. German 5yr +12bp), the dollar strengthened in FX markets, resuming its singular appreciation path. With a strong US economy contrasting with a weak European economy, the market probably expects the Fed to sharpen its hawkish stance at Jackson Hole. It appears likely that the market has broken out of its traditional shared global pattern of a strong economy leading to inflation and is now moving on the assumption of different conditions in each region.

5Y US/German Interest Rate Differential, EUR/USD Rate



Source: Bloomberg; compiled by Daiwa Securities.

Dollar Index (DXY)

Source: Bloomberg; compiled by Daiwa Securities.

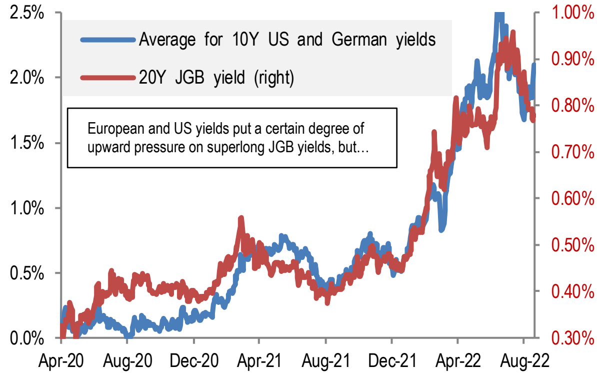
◆ <u>It has become relatively easy to invest in JGBs</u>

The large increase in European and US interest rates that occurred last Friday is also putting some upward pressure on JGB yields. With the focus on regional conditions, however, Japan's lack of a strong economy and absence of rate hikes create a favorable environment for bonds and should continue making JGBs look relatively attractive.

Next we consider whether the strengthening of the dollar vs. the yen will reignite expectations of the BOJ normalizing policy. Because those expectations faded after the BOJ clarified its near-term stance at the June and July policy meetings and given also that the dollar's strengthening against the euro cannot be explained by US/European interest rate differentials, we think it has become less likely than it was the first half of this year that interest rate differentials will drive the market and that it is expectations of rate hikes that have pushed the yen higher (the media coverage focused on BOJ Governor Kuroda's "stubborn stance" that has been fueling yen depreciation has quickly died down).

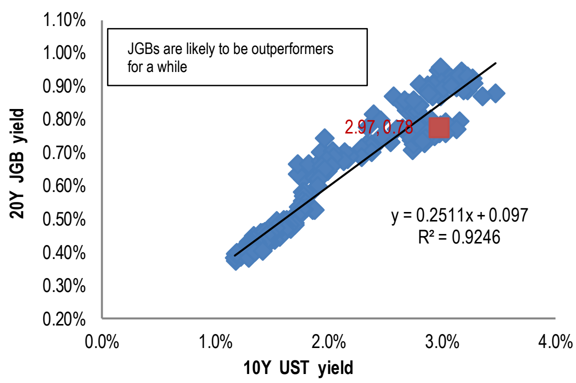
As our senior FX strategist Kenta Tadaide pointed out, "although rate hikes based on a strong economy (fundamentals) will strengthen a currency, self-destructive rate hikes that further weaken an already weak economy are unlikely to lead to a currency's appreciation." The wider recognition of this is one reason why JGBs have been performing better than they were in the first half of the year. The stronger that US economic data looks over the near term, the more likely the dollar's singular rise is to accelerate.

20Y JGB Yield, Average for 10Y US and European Yields



Source: Bloomberg; compiled by Daiwa Securities.

10Y US Yield, 20Y JGB Yield (scatter diagram, Jun 2021-present)



Source: Bloomberg; compiled by Daiwa Securities.

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